

August 29, 2001

CYCLES: Aside from questions about gold, I think I receive more questions and comments about cycles than almost any other subject.

As very long-time subscribers know, I've written a lot about cycles, waves, Elliott, fibonacci, etc. I don't write very much about cycles now. I guess I've come to believe that although cycle work is interesting and often fascinating, it just isn't trustworthy enough.

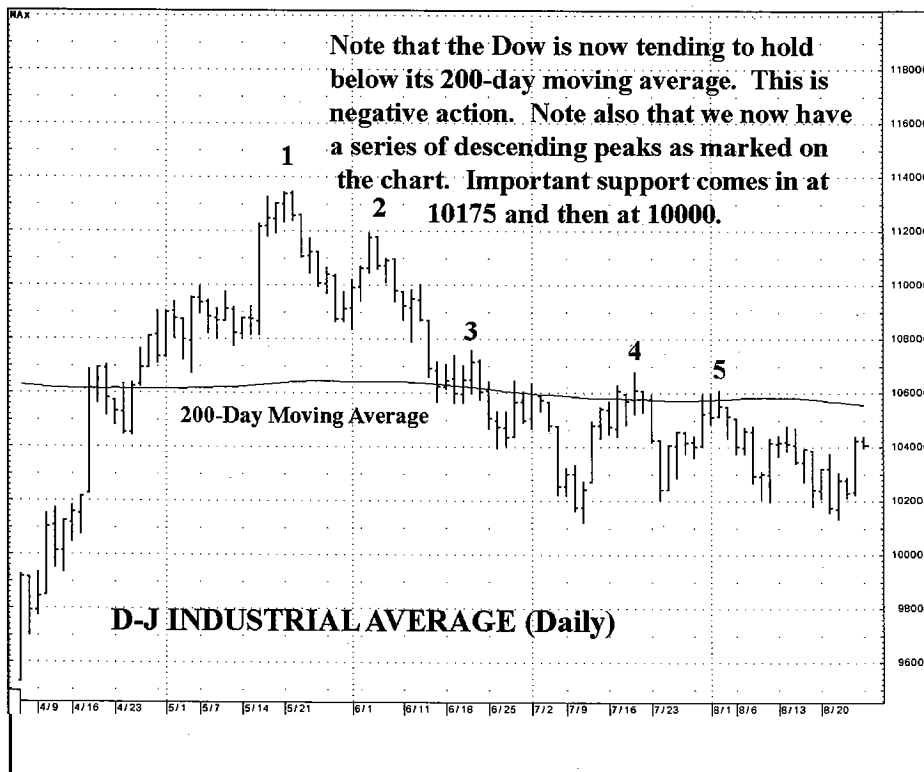
There's just too much excusing and reinterpretation when a cycle doesn't work. I've often said about cycles, "Where are you when I need you?"

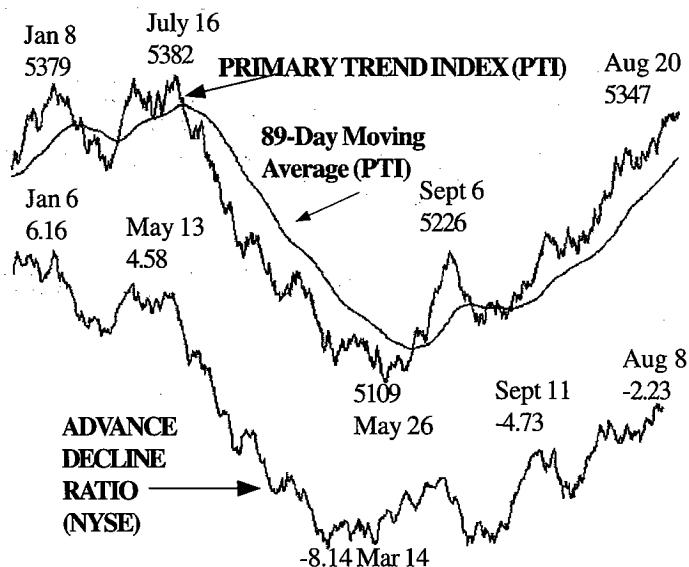
I've also stated that the only cycle I really trust is the cycle of values (which can often be expressed in terms of price/earnings and average stock yields). But most cycle-fans like to deal with periodicity. There's absolutely no periodicity in the cycle of values.

The cycle of values is based on human emotions. When investors become too optimistic about stocks, they run up the price/earnings ratio, and in the most recent case they ran up the P/E ratio for the S&P to a never-seen-before 33 times record earnings. Previous bull markets peaked with S&P P/Es at nearer 23.

August 10, DJIA 10414.30; PTI 5346; A-D Ratio -1.89
August 17, DJIA 10239.22; PTI 5341; A-D Ratio -1.52
August 24, DJIA 10423.17; PTI 5349; A-D Ratio -1.27
Dow yield: 1.73 Dow p/e: 26.3
Gold 50-day MA: 272.10

Furthermore, the recent bull market generated such enthusiasm for the "sure-fire" capital gains that corporations led people to believe that dividends were no longer necessary, that investors should and could be satisfied with the annual "almost guaranteed" rise in the price of their stocks. Thus, we had one heck of a bull market with the dividend yield on the S&P dropping close to 1% (the dividend yield on the S&P 400 Industrials actually sank below 1%).





During the year 2000 we saw the greatest extremes in stock market optimism ever recorded. That was one end or terminus of the value cycle. Stock values during the year 2000 went off the charts and into the record book.

A primary bear market is now in progress. If the value-cycle is valid and still operative, one way or another the market is going to go to the opposite end of the spectrum. I have to hope that we won't record new records in downside extremes, but as we all know, "the stock market can do anything." Also, in recent years items tend to go "further in either direction than anyone thinks possible." Examples: the US stock market, tech stocks, Japanese stock market, US housing, coffee, gold and palladium.

The frustrating part of the value cycle is that it can't be timed. There's no periodicity in the value cycle, and for that reason, although it's been the surest of all cycles, true cycle-adherents pretty much ignore the value cycle. Cycle adherents want either form (Elliott) or periodicity. The value cycle has neither. What it does have is certainty.

I have, of course, written about periodicity in past Letters. Just to refresh your memory, let's go over a few of those periodicity cycles. One came from a letter which I received from David Armstrong Poor of Briarcliff, New York.

Pool noted that there was a bull cycle that ran from **1914 to 1929**, during which time the Dow rose 620% over a period of 15 years.

Then there was a bear cycle that ran from **1929 to 1949**, during which the Dow lost 58% of its value over 20 years.

Next there was a bull cycle that saw the Dow rise from **1949 to 1966**, during which time the Dow gained 520% over a period of 17 years.

Following that came a bear cycle that saw the Dow decline from **1966 to 1982**, during which time the Dow eroded or went nowhere for a period of 16 years.

And most recently, we saw a huge bull cycle that saw the Dow rise over 900% over a period of 18 years, from **1982 to 2000**.

Then my old friend and outstanding market student, Robert Powers sent me the results of his cycle research. Robert noted that there were strong cycles and weak cycles. The average inflation-adjusted annual gain during the weak cycles was zero, while the average inflation-adjusted annual gains during the strong cycles were 14%. Just to refresh your memory, here are the most recent of the Powers cycles including stock appreciation or depreciation.

Weak Cycles:

1902-21 + 0.0% over 19 years.
1929-45 + 0.8% over 20 years
1966-82 -1.4% over 16 years.

Strong Cycles

1921-29 +25% over 8 years
1949-66 +14.0% over 17 years.
1982-99 +14.9% over 17 years.

What's interesting and probably significant about Poor's cycles and Powers' cycles is that both analysts show that their bull cycles end around 1999 to 2000.

This coincides with Robert Prechter's Elliott studies. Prechter shows that either we have passed the peak of the great bull market or that the Dow may have one more shot at a new high before declining in what he believes will be a catastrophic bear market third wave to the downside.

We also have the four-year Presidential Cycle which states that the market tends to be weak in the first year of the new president's reign. Which is where we are now.

Then we have the strict periodicity cycles, which include the longer 4 to 4.5 year cycle, the 32 to 43 month cycle, the 78 to 79 week cycle, the 40 week cycle, the 39 week cycle, the 20 week cycle, and the 10 week cycle. Those cycles cover about every contingency.

According to my old friend and cycle expert, Ken Gammage of Richland here in La Jolla, an important "nesting" of cycle lows is due to materialize between now and early-September of this year.

Finally, we have what I call the "warning statistics," which are simply based on past case histories. The statistic that applies today is this: When the price/earnings ratio for the S&P is 22, the median appreciation for the S&P is 0.5% over the coming ten years. I guess I would call this part of my value cycle.

Figures were based on average dividend yield, which over the years ran about 4.5%. But dividend yield is now 1.3% for the S&P and the P/E for the S&P is 26. Therefore, it is doubtful whether the S&P over the next ten years will even be able to generate a median annual return of 0.5%. My guess is that it will be less, maybe considerably less, considering the extreme to which the late bull market reached.

If I had to guess, I'd guess that investors over the next ten years will, on balance, lose money holding stocks, holding them, as they say, "for the long haul."

SOLD-OUT MARKETS: Market students tend to misunderstand the meaning of a sold-out market. There are two types of oversold or sold-out markets.

The first is the "normal" oversold market that can and does appear during either bull markets or bear markets. This situation is merely indicative of a market that has gone down excessively. It's usually a technical situation where too many people get too enthusiastic about the downside, accompanied by stocks which have overrun themselves on the downside. To put it another way, it means that the downside of the market has become too obvious and too popular.

These situations can occur during primary bull markets and primary bear markets. In fact, these situations may occur twice a year or as far apart as three or four years.

But there is another version of the oversold market, and it has to do with VALUES. **Great market bottoms** are accompanied by both an oversold market condition and GREAT VALUES.

For instance, let's say that the current market heads down into a low around the middle of October. That low may identify a very oversold market, and it may place the market (and traders) in position for an excellent advance.

But for a number of reasons, I doubt that any coming October low would represent the end of this bear market. For one thing, price/earnings ratios would still be above 20 and the yield on the S&P would be, well, let's say 2.3%. Hardly great values. Just less expensive than in August.

Now let's take another theoretical situation. It is 2004, and the price/earnings ratio on the Dow is 12. The Dow is yielding 4.5%. The stock buying public has turned bearish, and almost everyone is dealing with losses.

The market heads down again, and the talk is that "An-

other year like this and you can say goodbye to capitalism." People are wondering how they ever got into the stock market, and the unemployment rate in the nation has risen to 8%. The market declines and the blue chips collapse. The P/E on the Dow drops to 8 and the Dow is yielding 6 %. The Dow has made a low a few days ago, but the Transports have not confirmed. Suddenly, the market goes dead. Analysts are talking about the Dow dropping another 30%, since earnings are atrocious.

The market, by any measure, is oversold. Stocks are incredibly cheap, based on any gauge you care to use. This is a primary bottom. This is the place where some top blue-chips are yielding 10%. This is the place where you either buy stocks (of course you're sweating) or the country's not going to make it, and neither will you. You close your eyes, you call your broker, and you place your orders.

You've got it right this time. This oversold condition is the ultimate bottom of the bear market. And you're in, Buster, you take your big chance and you put down your money. And you've got it right – you bought within 5% of the bottom in one of the greatest oversold markets of all time.

INVESTMENT POSITION: The bear remains in

the box. I want to start this section by explaining my own investment position.

Almost all in municipal

bonds. With the stock market still extremely expensive, with stocks offering little or no yield,

I own a few utility stocks

but mostly high-grade municipal bonds.



First and most important—I don't gamble. I've been to Las Vegas a few times and I never spent a cent on the slots or on any other "game." I don't gamble in the markets either. I compound. I buy only securities that throw off either dividends or interest. I re-invest the money that comes in. With the money

that comes in I buy other securities.

I'm in no hurry. Right now I believe stocks are flagrantly overvalued. So I buy notes or bonds, preferably tax-free muni bonds.

What about buying stocks here? They are just not values at these prices, so I feel that buying stocks at these prices is pretty close to outright gambling. Furthermore, if I thought the stock market was at a great oversold "buy spot," what I'd do is buy either Spyders, which are ETF proxies for the S&P, or I'd buy S&P futures.

Let me put it this way—I feel when speculating for a move, it makes far more sense to buy the move rather than try to pick the stocks that will lead the move.

NOTES & QUOTES: Forrester Research predicts that e-commerce (now \$657 billion) will reach \$6.8 trillion annually by 2004. And on its orange juice container Tropicana states that "82% of Americans don't get enough potassium."

How the hell does Forrester know that e-commerce will reach \$68 trillion annually by 2004? And how in the devil does Tropicana know that 82% of Americans don't get enough potassium? My guess -they're just guessing.

It reminds me of the story of the high school kid who was coming up with amazing statistics on a variety of different items. Someone finally asked him, "How do you remember such an incredible variety of statistics?" The kid answered, "I don't remember them, I just make them up."

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Analysts have been dismally wrong so far on the economy. When a closely watched gauge of factory activity ticked up slightly in February for the first time in a year, analysts pounced on this as a sign that the worst was over. It didn't happen. Now in late August

factory activity is still down, and analysts are still talking about the upturn ahead, and ahead and ahead.

Greenspan, no genius at predicting what lies ahead, noted the “exceptional weakness” that gripped the economy last year hadn’t continued into January. The Green man then predicted that the economy would grow between 2% and 2.5% this year. In July Greenie lowered his forecast to 1.5% to 2.0%. He still may be too high.

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Mark Twain said it, “Whiskey’s for drinking, water’s for fighting about.” The UN just issued its warning – one in three people won’t have access to sufficient water by 2025. It warns that clashes loom ahead.

Writes Paul Simon in today’s OP/Ed column of the New York Times, “Nations go to war over oil, but there are substitutes for oil. How much more intractable might wars be that are fought over water, an ever scarcer commodity for which there is no substitute.

“Last year American intelligence agencies told President Clinton in a worldwide security forecast, that in 15 years there will be a shortage of water so severe that if steps are not taken soon for conservation and cooperation, there will be regional wars over it.”

Russell Comment: Believe it. The largest private water company in the US is American Water Works (AWK). I’ve been recommending this stock for years. Everyone should own some shares of AWK. The company, by the way, has a history of raising its dividend every year. It also has a history of buying out other water companies.

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Battle of the Giants: AOL Time Warner and Microsoft both want to “own” the Internet. AOL paints MSFT as a desktop monopoly and itself as a victim. AOL says it will pay computer-makers to feature its e-mail service rather than Microsoft’s and it’s lobbying lawmakers to legally force MSFT to let that occur.

But the heart of the battlefield is the PC, where MSFT is ready to extend its power with the XP software. For other tech companies, this fierce battle couldn’t come at a worse time. The industry is now in a deep slump, and a lot of firms hope that Microsoft’s XP will set off an upswing in new PC purchases.

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An interesting article appears in the September issue of *Worth* magazine. The article’s headline is, “Mr. Buffett, Your Time is UP. The article starts, Buy-and-hold investing was never as smart as Warren Buffett made it look. Today the strategy may even prove dangerous to your portfolio.”

Russell Comment: The writer doesn’t know what he’s talking about. Buffett is a compounder of businesses. Buffett knows exactly what he doing. He buys **basic** businesses that will be around 5, 10, 25 years from now, businesses like soft drinks, razors, bricks and mortar, candy, furniture, insurance (never a tech company). Buffett buys businesses that throw off money. No profits, no money being thrown off, no interest from Buffett. And, of course, Buffett is smart enough to keep all the money, meaning no dividends to his stockholders.

When he buys a business he collects the profits and buys other businesses. Buffett loves a bear market, because that’s when he can buy additional businesses on the cheap. So years go by and more and more money comes in, and Buffett buys more and more businesses. And over the years this compounding process continues to push up the assets and net worth of Berkshire. Buffett knows two things – value and the power of compounding.

And as I said above, the writer of the *Worth* article (Adam Hanft) doesn’t know what the heck he’s talking about. And I have to wonder how Hanft has done in the investment business.

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A very interesting and different “take” on the economy is furnished by “Charting the Economy” 1-

877 – 607 – 4639. This outfit offers a lot of unusual charts that I've found very interesting and provocative. Ask for a sample.

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This from the latest issue (September 3) of *Fortune* magazine. "Consumer debt has sailed into uncharted territory. Household borrowing had been growing steadily since the mid-1980s before positively exploding during the last decade. It now stands at a record \$7.4 trillion, almost double what it was at the beginning of the 1990s. Interest rate payments as a percentage of income have jumped from 2.2% to 3.2% since 1995 even though interest rates themselves have been falling. Debt service as a percentage of income is close to 14.5%, another record.

"And for the first time in history, American households are carrying a debt burden equal to their combined after-tax income. Obviously, there's a debt level at which debt-fueled consumption suddenly stops helping and becomes really, really bad for the economy. Trouble is, no one is sure exactly where the tipping point is, which makes it awfully hard to predict how this whole debt thing is going to play out.

"Home-owners may have taken on a greater risk too. The rule of thumb used to be that a household spent at most 20% of income on rent or a mortgage. Now one in five 2-income families is spending more than half its income on housing."

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Dow Jones recently collaborated with Germany's Deutsche Boerse. Starting next month, European trading data will be used to expand the Dow Jones Industrial Average's reach to 13 hours. The "indicative Dow," as it is called, will consist of data collected from 3AM to 9:30AM EST, when European markets are trading.

Russell Comment: We don't really need this since we already have all night trading of the S&Ps on Globex. But it will be interesting.

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I write part of every daily site in the morning where at the office we have T-1 which speeds up the Internet connection to a remarkable degree. When I write a paragraph and hit save, the paragraph is saved in about three seconds at worst.

At home I have Time Warner's Road Runner. I write the second part of the site after the market closes at a time when the Internet gets busy. At that time, when I save a paragraph it sometimes takes me almost five minutes (which is maddening), whereas T-1 would take a few seconds. The only problem with T-1, it's expensive – costs about \$650 a month. We have our site running on T-1, but obviously T-1 is too expensive for most homes.

NOTICE TO OUR WEB CLIENTS: We are now posting our Dow Theory Letters on our website. We have absorbed postage and paper increases and have not raised our prices for 10 years. We would appreciate your assistance with the conservation of paper, postage and printing expenses. We intend to cease mailing (via US Post Office) the Letter to those subscribers who have signed up for our web service. However, if you wish to continue receiving the Letter via the US Post Office, you must let us know, either via an e-mail to us (send to staff@dowtheoryletters.com) or by regular mail. A return form and envelope is enclosed as well. Thank you for your help.

LATE NOTES: What's wrong with this market. One word: chronic overvaluation. Today you're paying a dollar for 4 cents worth of earnings and literally no dividends. Listen to the words of George Schaefer, the great Dow Theorist of the 1940s and '50s.

"Dow seldom mentioned the pattern of the Averages, yet most Dow Theorists of today seem to think that by plotting of the dual averages is the prime consideration. Nothing is further from the truth. Anyone who has made a study of Dow's editorials knows that the buying of good values (which is characteristic of investment buying) and the selling of poor values (which usually comes at a time when the public is doing its heaviest buying) is the essence of Dow Theory. "

NEXT MAILING: September 19, 2001